

## CONSUMER THEORY

A more in-depth look at the forces  
that shape our demand

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## Consumption

- so far, we have looked at demand/supply, but have not looked at the true influences of either; we will focus on demand in this section
- We know that household consumption choices are limited by:
  - 1) Income available
  - 2) Price of the product

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## BUDGET CONSTRAINTS

- **BUDGET CONSTRAINT:** represents the possible combinations of 2 commodities that a consumer can purchase, given:
  - 1) market price of the products
  - 2) consumer's income

This is a consumer's "consumption possibilities" frontier

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## Shifts of Budget Constraints

- What happens when we shift the budget constraint by:
- Changing income
- Change one price
- Change both prices
- Allow for borrowing (credit cards, etc.)

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## PREFERENCES AND UTILITY

Q: What determines your actions in every facet of life???

A: The notion of "rational self-interest"

- What helps fuel self-interest???  
"Benefit vs. price" - get the most benefit you can, but there is a constraint (income/price)

How does one measure pleasure - "UTILITY"

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## Utility

- Measure of pleasure or satisfaction one gets from consuming a product
- - measured in "utils"

So, the consumers objective is to maximize utility given their budget constraints

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## Utility

- **TOTAL UTILITY (TU)** Number of units of utility a person gets by consuming a given quantity of the product during a particular time

**MARGINAL UTILITY (MU)** amount by which an additional unit of the product increases a consumer's total utility

Why can marginal utility be viewed as more important in the decision making process than total utility?

### **LAW OF DIMINISHING MARGINAL UTILITY**

Beyond some level of consumption, the marginal utility of a product will decline as the quantity consumed increases

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## MAXIMIZING UTILITY

Goal of consumer is to maximize utility subject to its budget constraint

PROBLEM: How to allocate income among the possible consumption choices.

Each time I buy a good, what happens?

- 1) utility increases, but at a declining rate
- 2) give up opportunity to buy other goods

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## Marginal Decisions

- Decisions are made “on the margin”

How do we compare the MU of two different goods?  
Can we look at just the MU of each product

Gains in utility possible when marginal utility per dollar of one good exceeds that of another good.

For two goods (X,Y), the consumption decision rule is:  
Consume good X as long as its MU/\$ is greater or equal to that of good Y

$$\text{Decision rule: } MU_X / P_X \geq MU_Y / P_Y$$

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**Consumption Decision**

- As long as  $MU/\$$  is not the same for all goods, the consumer can reallocate income to buy more of the goods that have higher  $MU/\$$  than the others.

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**Consumer Equilibrium and Total Utility Maximization**

- **CONSUMER EQUILIBRIUM** The consumer purchases goods until  $MU/\$$  is the same for all goods. When this occurs, and all available income is spent, total utility is maximized.

Total Utility is maximized by marginal decisions

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**DEMAND CURVE REVISITED**

- We've discussed that the law of demand dictates that the demand curve is downward sloping - here is another way to prove it
- Use of the law of diminishing marginal returns and consumer equilibrium to show this.

Diamond-Water Paradox: Why do diamonds cost so much more than water, when water is essential to life?

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CRITICISMS OF MARGINAL UTILITY  
THEORY

- Utility cannot be observed
- People aren't "smart enough" - aren't "rational thinkers"
- Forces people to put a \$value on goods

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